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Testimony

AD-A264 737



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MAY 24 1993
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For Release
on Delivery
Expected at
9:30 a.m. EST
Thursday
March 14, 1991

Bank Supervision: Prompt and Forceful
Regulatory Actions Needed

Statement of
Charles A. Bowsher
Comptroller General of the
United States

Before the
Subcommittee on Financial Institution
Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives



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Bank Supervision: Prompt & Forceful Regulatory Actions Needed

SUMMARY OF STATEMENT BY
CHARLES A. BOWSHER
COMPTROLLER GENERAL OF THE UNITED STATES

GAO's testimony today covers the enforcement process used by bank regulators to correct unsafe conditions or practices found in banks. GAO calls for changes aimed at achieving prompt and predictable regulatory responses to problem conditions in banks.

GAO's study was conducted by reviewing the enforcement histories of a random sample of 72 banks from the universe of banks having capital difficulties as of January 1, 1988. These 72 bank cases came from three geographic areas and were equally divided among the three federal regulators--the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve System.

GAO's review of the enforcement histories resulted in two main findings:

- (1) Regulators usually found that problems in bank assets, earnings, or management were causing the capital difficulties. Management weaknesses typically led to problem loans, which subsequently led to high losses as these loans defaulted, and ended in capital difficulties. Despite this seemingly obvious progression, regulators focused their enforcement actions on capital, not the underlying causes of capital depletion. As a result, the earliest opportunities to correct emerging problems were not utilized by regulators.
- (2) Bank regulators have considerable discretion in choosing among enforcement actions of varying severity to correct a specified problem. When the regulators used the strongest actions available to them, banks were more likely to improve. Conversely, when the regulators chose less stringent actions, the banks in question generally did not improve. Overall, GAO believes that in 37 of the 72 cases stronger actions could and should have been taken by the regulators.

GAO believes the effectiveness of bank supervision would be improved by developing a "tripwire" system of supervisory enforcement that would consist of

- (1) industry-wide measures of safety and soundness for asset, management, and earnings conditions to complement capital standards and
- (2) a prescribed set of increasingly forceful actions to be taken when a bank does not satisfy these measures.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our work, done at your request, on the effectiveness of the federal bank regulatory supervision and enforcement process. Today, I will discuss how the three bank regulators--the Office of Controller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve System--use their enforcement powers to deal with banks that they have identified as having problems in meeting minimum capital standards.

Effective supervision of banks is a crucial issue in congressional deliberations about deposit insurance reform. Deposit insurance was designed to restore confidence in the banking system after the failures and losses of the Great Depression. For the most part deposit insurance has worked, giving the Nation a stable banking system through the various economic difficulties of the past 60 years. But as we learned in the savings and loan industry debacle, this stability has required that taxpayers be willing to fund deposit insurance shortfalls.

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In our view, reform must preserve the benefits of deposit insurance--a stable banking system--but reduce the potential costs to taxpayers of insurance shortfalls. We need reform because banking is no longer the protected industry that it was 60 years ago. Today, banking risks are greater because

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competition is greater. We see evidence of these greater risks in the increased number of bank failures and the large losses being posted by the Bank Insurance Fund.

We have developed a three-part reform proposal aimed at maintaining the stability of our banking system and lowering risks and costs to the taxpayers from deposit insurance guarantees. Our proposal aims to

- (1) strengthen the way banks are regulated and managed by giving regulators the mandate, information, and resources to take prompt action to resolve problems at all banks--but particularly larger ones--when these problems first become evident;
- (2) change the economic incentives of depository institutions through strengthened capital requirements, risk-based insurance premiums, and other means to ensure that owners, managers, and creditors--not the taxpayers or the insurance fund--bear most of the costs of bank failures; and
- (3) update bank holding company structure and regulation to reduce risks to the banking system and prepare for financial system modernization if expanded powers for bank and other financial institutions are judged desirable by Congress.

You will notice that strengthened bank supervision is at the top of our agenda. Bank regulators should assure that safe and sound banking practices are followed and insurance losses are contained. Unfortunately, our work on the supervision and enforcement process shows that it is not effectively achieving this objective. The process needs to be more predictable, more credible, and less discretionary.

Currently, regulators monitor the practices and conditions of banks through off-site monitoring and on-site examinations. When examinations identify unsafe or unsound banking practices or conditions, regulators can take enforcement actions to get problems corrected. We studied the regulators' actions to enforce safe and sound banking practices by analyzing 72 banks that were identified by regulators as having difficulty meeting the minimum capital standards as of January 1, 1988. These 72 cases were randomly selected from three areas of the country and were divided equally among the three federal bank regulators.

Our analysis of the examination histories of these 72 banks led to two important observations:

- (1) Regulators usually found that problems in bank assets, earnings, and/or management caused the capital problems. Despite this seemingly obvious result, regulators focused their enforcement actions on measures of capital, not the

underlying causes of capital depletion, and were reluctant to take action until minimum capital was depleted to or below required levels. Therefore, the earliest opportunities to correct an emerging problem were not utilized by the regulators.

- (2) Bank regulators have considerable discretion in choosing among enforcement actions of varying severity to correct a specified problem. When the regulators used the most forceful actions, the banks were more likely to improve. Conversely, when the regulators chose less stringent actions, the banks in question generally did not improve. Overall, we found 37 cases where we believe more forceful actions could and should have been taken by the regulators. Therefore, regulators may not be using the tools and authorities available to them in the most effective way possible.

CAPITAL DIFFICULTIES FLOWED FROM OTHER PROBLEMS

When we drew our sample of 72 banks, all were having capital difficulties and a high percentage of them were having management, asset, or earnings difficulties as well. For example, regulators had identified management problems in 82 percent of the banks, earnings problems in 71 percent, and asset problems in 96 percent of the banks.

We tracked these problems to see whether regulators had just learned of them or whether they had been identified earlier. We found that in a significant number of banks, not only had these problems been identified at least one year earlier but regulators also viewed them as serious enough to eventually affect capital. For example, more than one year earlier, 47 percent of these banks had serious management problems, 71 percent had serious earnings problems, and 61 percent had serious asset problems pinpointed by the regulators as potential threats to capital adequacy.

The factors leading to capital difficulties were similar for banks that eventually improved their capital condition and for those that did not. In both groups, regulators identified asset and earnings problems such as high loan or operating losses, and excessive asset growth. The asset and earnings problems that regulators identified were often traced to the quality of management decisions and practices. The following table shows the specific management problems cited by regulators in our sampled banks.

The management problems most frequently cited by regulators involved a lack of expertise by bank management or a passive board of directors.

Table 1: Types of Management Problems^a

<u>Type of Management Problems</u>	<u>Number of Banks</u>
Management lacked needed expertise	27
Passive board of directors	25
Unwillingness or inability to address prior enforcement actions	21
Inadequate/lack of system ensuring compliance with laws & regulations	15
Directors lacked needed expertise	13
Key positions inadequately staffed	13
Insider abuse or fraud	13
Dominant bank official	10
Dominant board member(s)	9

^aThese reasons were cited by regulators in at least 9 of the banks we reviewed, and more than one reason may have been cited for each bank.

Regulators also cited internal control weaknesses such as inadequate lending policies or poorly controlled lending practices that led to asset problems. Our sample results are consistent with a recent OCC study that found internal management factors, such as inadequate policies and procedures, have a greater influence on the bank's success or failure than external economic conditions.

Despite the seemingly obvious progression of problems leading to capital difficulties, there are not clear-cut, widely accepted measures of unsafe and unsound practices except that which exists for capital. As a result, the focus for enforcement is on capital--a valid, but lagging indicator of the safety and soundness of a bank's operations--rather than on the factors that are leading to capital depletion. Regulators have developed

threshold measures of unsafe conditions. Indeed bank examiners often identified these types of problems as needing remedial action. But minimum conditions governing asset, earnings, and management performance have not been specified in regulations.

BETTER RESULTS WERE ASSOCIATED WITH USE OF FORCEFUL ACTIONS

Of our 72 sampled cases, 22 banks improved both their capital levels and the underlying cause of their capital problems. In 15 of these "best-outcome" cases, regulators had taken the strongest actions available to them given the circumstances in those cases. Conversely, 20 banks improved neither their capital nor addressed the underlying causes of their capital difficulties. In 14 of these 20 "worst-outcome" cases, regulators had chosen not to use the strongest formal enforcement actions that were available to them.

Regulators were frequently reluctant to take the strongest actions. They favored working with cooperative bank managers to get them to address identified problems. OCC consciously decided in the mid-1980s to change its philosophical approach to one of trying to work more cooperatively with bank managers to encourage them to make necessary improvements rather than imposing formal enforcement actions to compel managers to act. While FDIC and Federal Reserve officials did not suggest such a conscious decision to change their philosophy, they too expressed a

preference for working with cooperative bank management rather than imposing formal enforcement actions.

We do not object to regulators working cooperatively with banks as long as they are actually responsive in addressing the safety and soundness problems identified. But, if the cooperative approach is carried too far without obtaining positive results, it can prove damaging over the longer term because underlying problems can become intractable. Thus, there is a point in the regulatory process where more forceful actions need to be brought into play. We believe the present regulatory practice extends that point too far.

For example, we identified 37 cases in our sample where we believe regulators could and should have used stronger enforcement actions. These 37 cases consisted of banks that had not corrected the underlying causes for their capital difficulties or had a history of noncompliance with regulatory requirements and enforcement actions. Twenty-four banks had both situations yet regulators declined to take stronger enforcement actions.

The reasons cited for not taking more forceful enforcement actions in these cases were consistent with the regulators preference for working with bank management rather than deciding that an adversarial approach was necessary. The reasons cited

were also consistent with the regulators' reliance on capital as a measure of a bank's financial health and viability. Regulators clearly did not want to take an enforcement action that they believed would potentially damage the bank's ability to attract capital through injections, stock offerings, mergers, or acquisitions; nor did they want to take action until capital levels fell below minimum standards. Yet, in a number of cases anticipated capital infusions never materialized. Even when capital infusions did occur, all too often the causes of capital depletion were not addressed. In these cases, regulators expected that restored capital would eventually be depleted.

MORE CERTAINTY COULD IMPROVE THE REGULATORY PROCESS

Better focus and greater certainty would improve the outcomes from the bank regulatory process. In particular, the process would benefit by establishing

- industry-wide measures of safety and soundness for asset, management, and earnings conditions to complement the capital standards and
- a prescribed set of increasingly forceful enforcement actions to be taken when a bank does not satisfy these measures.

Such measures established in regulation would provide benchmarks for corrective action by all parties involved--bank managers as well as regulators. We believe such a "tripwire" system would help both the regulators and bank management focus on problems that, unless corrected, will likely lead to capital deficiencies

GAO's Tripwire System

We have recently proposed in our report on deposit insurance¹ reform that the Congress require the bank regulators, in consultation with the banking industry, to develop a formal regulatory "tripwire" system that requires prompt and forceful regulatory action tied to specific unsafe banking practices--not just to capital levels. We envision this approach categorizing unsafe banking conditions and the regulator's response into phases of intervention that become increasingly more severe as a bank's condition deteriorates. The interventions could occur in the following four phases.

In phase 1, regulators would have identified problems with internal or management controls over banking operations which have not yet resulted in high levels of non-performing assets or operating losses. Regulators could impose growth and interest

¹Deposit Insurance: A Strategy for Reform, GAO/GGD-91-26, (Mar. 4, 1991).

rate restrictions, and require higher capital requirements and/or insurance premiums if improvements are not made.

In phase 2, there could be serious asset deterioration and earnings problems. These problems could lead to growth and interest rate restrictions, higher capital requirements and insurance premiums, reduced dividend payments, or civil money penalties.

In phase 3 if capital deteriorated below minimum requirements, the regulators could require a recapitalization plan, suspend dividend payments, and undertake a bank break-up analysis.

In phase 4, if a bank has depleted its capital, the regulator could place the bank in conservatorship, and liquidate, merge, or sell it.

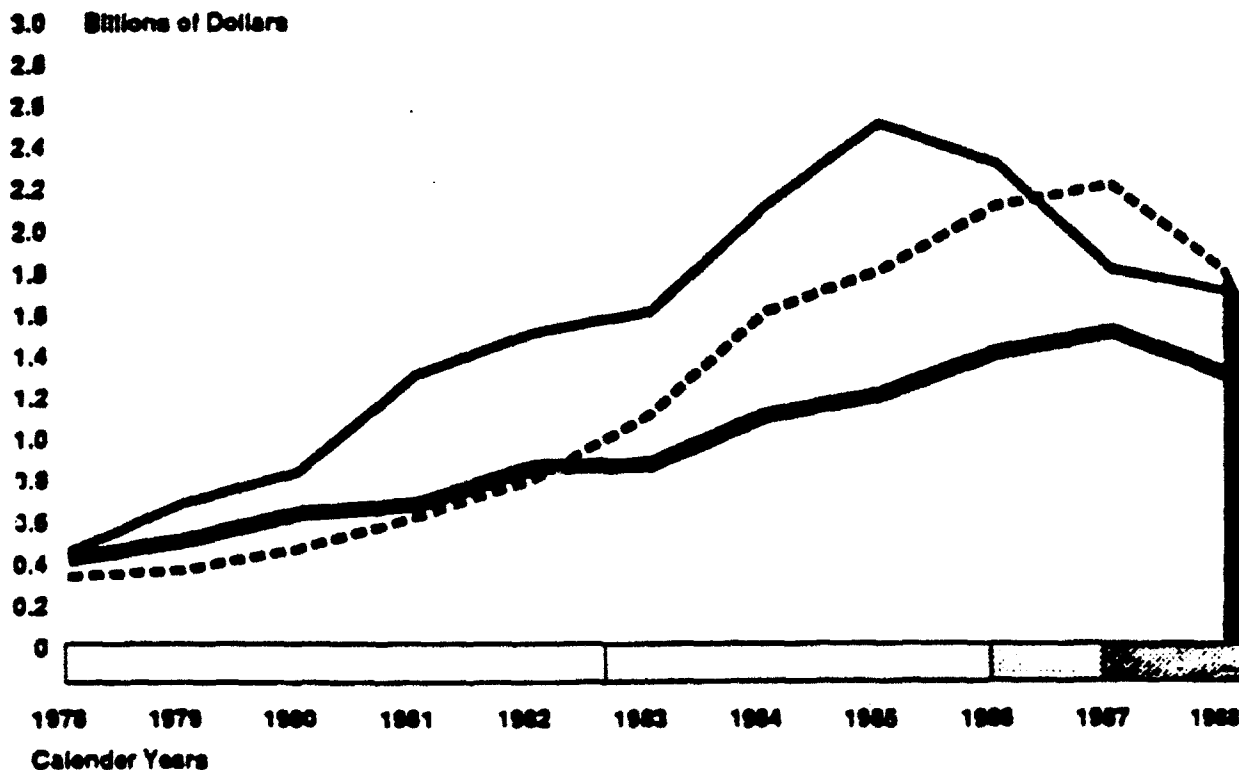
Under this approach to supervision and enforcement, regulatory discretion in dealing with identified problems would be limited, and owners and managers of insured banking institutions would know in advance the consequences of actions that could potentially weaken the financial strength of their institutions.

The tripwire approach to enforcement that we envision is not without precedent. Under SEC rules, once a broker-dealer's capital falls below the minimum capital requirement, it must

cease operating even if it has positive levels of capital remaining. The securities industry has become accustomed to this rule and the consequences associated with violating it. We believe a similar beneficial result can occur in the banking industry.

I would like at this time to provide an example of how we envision the tripwire approach working. Figure 1 illustrates the loan growth history of a large banking organization that had engaged in a number of risky banking practices at least since 1978. There were clear, early warnings of unsafe conditions and practices. But the unsafe practices were not checked by bank regulators and further deterioration occurred. The bank eventually failed and is expected to cost the FDIC \$2.7 billion.

Figure 1: Tripwire Proposal Demonstrated Using Historical Loan Growth of a Failed Bank



- Commercial and Industrial Loans
- - - Real Estate Loans
- Other Loans



Tripwire 1:

Problems: Documentation deficiencies, rapid growth, lack of policy on loan concentrations.

Examples of Required Actions: Growth and interest rate restrictions, higher capital and/or insurance premiums.



Tripwire 2:

Problems: Serious asset deterioration.

Examples of Required Actions: Growth, interest rate, and dividend restrictions, higher capital and/or insurance premiums, civil money penalties.



Tripwire 3:

Problems: Capital below minimum requirement, high losses.

Examples of Required Actions: Recapitalization plan, stop dividend payments, break-up analysis.



Tripwire 4:

Problems: Depleted capital, continued losses.

Examples of Required Actions: Place bank in conservatorship, liquidate, merge, or sell.

Had a tripwire system been in place, Phase I tripwires would have been activated by 1978, at the point regulators had identified internal control deficiencies. From 1978 to March of 1982, the regulators identified problems, such as rapid growth and no policies controlling loan concentration. The phase I regulatory response would have included growth and interest rate restrictions, higher capital and/or insurance premiums. In this case, regulators reported the problems they found in the examination to the bank managers but took no enforcement actions.

Phase II tripwires would have been activated between mid-1982 and late 1986 when regulators noted serious deterioration in the quality of the bank's loan portfolio. The phase II regulatory response would impose restrictions on growth, interest rates, and dividends; as well as require higher capital and/or insurance premiums. Civil money penalties might also be imposed. Regulators actually entered into an informal written agreement with bank management to get the lending operations under control.

Phase III tripwires would have been activated during the period from late 1986 to late 1987 when the bank experienced significant losses and capital fell below minimum requirements. In a third-phase response, regulators would take actions to prohibit payments of dividends, require a recapitalization plan, and perform a break-up analysis. In actuality, regulators introduced no more stringent enforcement actions despite the

bank's further losses, its failure to meet capital standards, and the decision by the bank to pay dividends to its shareholders.

Phase IV tripwires would have been activated in 1988 when the continued losses at the bank completely depleted capital. The fourth-phase response would require regulators to place the bank in conservatorship, merge, or sell it. While a 1988 exam severely criticized the bank's rapid real estate loan portfolio growth and failure to properly document new loans, as far as we could tell, the regulator did not take further enforcement action. By that time, it was apparent that the bank would have to be closed, sold, or merged with another bank.

CONCLUSION

In conclusion, I would like to reiterate that deposit insurance has served the banking system and the country well for over 60 years. In the increasingly fast-paced, rapidly changing environment that the banking industry will face in the decades ahead, bankers, the regulators, Congress and the public need to know that the soundness of the banking system is protected by an enforcement process that is predictable and effective. While the current enforcement process is not broken beyond repair, it needs major reform to meet its objectives of ensuring safe and sound banking and protecting the deposit insurance fund.

This concludes my prepared remarks. My colleagues and I will be pleased to answer questions.

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